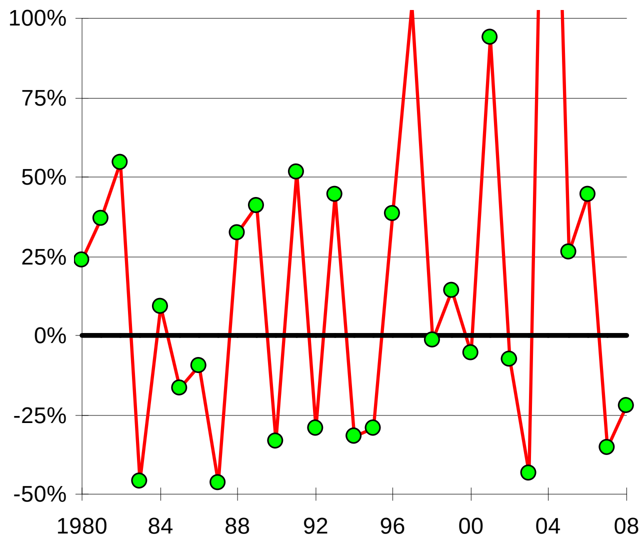
<u>Question</u>: " Why is the state severance tax revenue so variable?"

1) Severance tax is highly variable on a monthly and annual basis.

2) Severance tax is collected on the production of coal, metals, oil and gas.

3) Coal and metals provide less than 25% of the severance revenue and are fairly stable.

4) It is the revenue from the value of oil and gas production which provides the bulk of state severance tax revenue and is the source of the large variability.



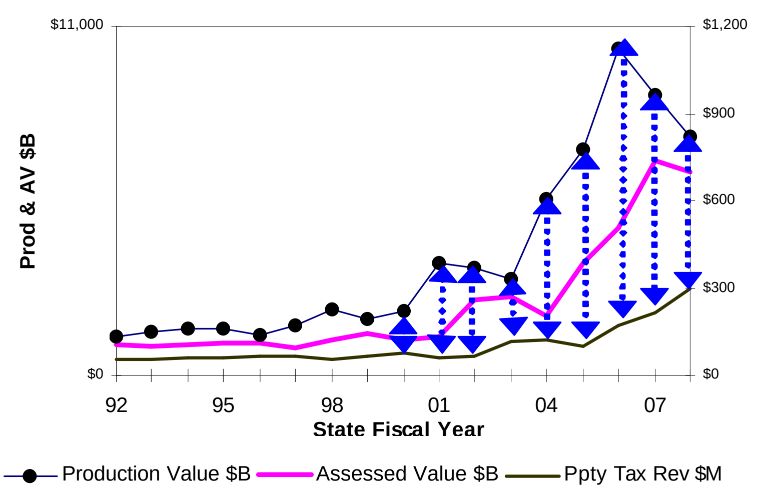
Annual Percent Change in Severance Tax Revenue

5) Severance tax revenue on oil and gas starts with the the value of production. From this the taxpayer deducts any produciton from small wells exempted from the severance tax. The taxpayer then deducts various costs from the remaining wells to get the valuation back to the point of severance. These two deductions combined total about 40% of production value. A 2 to 5% percentage tax rate is applied to the remaining valuation to get the gross severance tax liability. Most production is taxed at the 5% rate. Then the tax law provides for the subtraction of a large credit for property tax payments to determine net revenue paid to the state. Since property taxes in the rural production areas are often at the 50 mills or higher rates (5% of value), these property tax credits are about the same size as the gross severance tax liability. As a result, the property tax credit can frequently reduce the net severance tax liability of a particular producer to zero.

6) The effective tax base for the oil and gas severance tax is not the gross value of production. Rather, it is the GAP between the gross value of produciton and this large credit.

7) As the value of oil and gas production varies, the gross severance tax liability moves in concert. However, the property tax payments by an oil and gas producer are based on the assessment of production by the county assessor in the prior year,

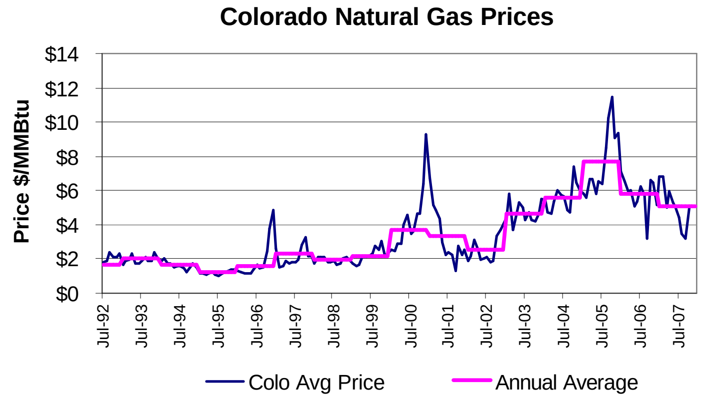
O&G Production Value, Property Assessed Value and Tax Revenue. The Two Year LAG



which is based on the value of production in the year before that. The interaction of this two year LAG in the calculation of the property tax credit with the gross severance tax calculation causes much of the high variability in net severance revenue.

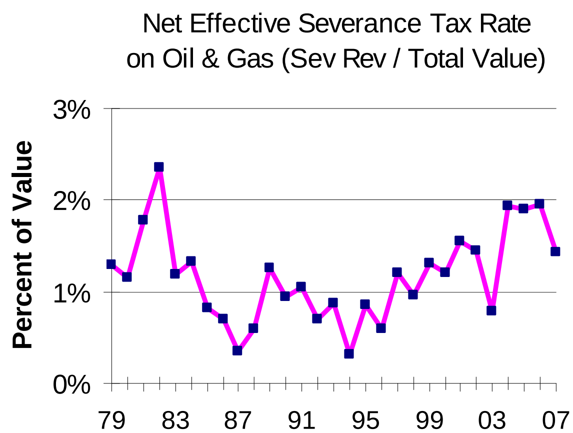
8) This lag in the administration of property taxes produces a gap between the current production value in a year (the black line) and the property taxes owed on production in that same year (the blue line), which are based on production value two years prior.

10) The variability in net state severance tax revenue is triggered by the huge swings in the price of oil and gas. Gas is now more than 80% of the combined oil and gas production value subject to severance tax.



11) The net effect is to have wide swings in the effective severance tax rate on the gross value of oil and gas production.

12) So, in the end we have a volatile tax rate on a volatile tax base. This volatility is structurally built into the severance tax law and into the extraction fuels markets.



March 14, 2008